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IRS Study Provides Preliminary Tax Gap Estimate

The Internal Revenue Service released preliminary results on March 29, 2005 from a major research project assessing compliance with the tax laws. The study reveals the vast majority of American taxpayers pay their taxes timely and accurately, but the nation still has a significant tax gap.

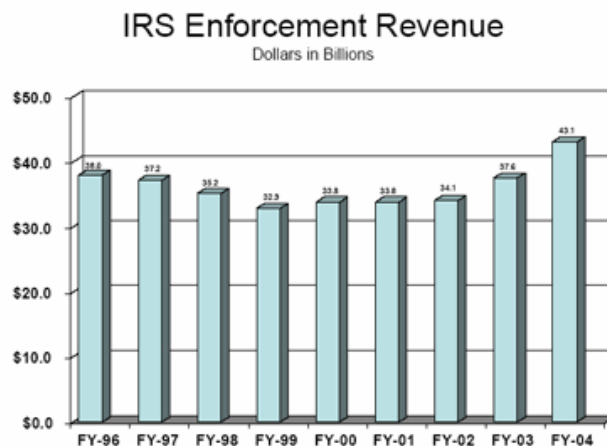
The preliminary findings show the gross tax gap — which is the difference between what taxpayers should pay and what they actually pay on a timely basis — exceeds \$300 billion per year. The results indicate the nation's tax gap increased slightly to between \$312 billion and \$353 billion in tax year 2001. This compares to the old tax gap estimate for 2001 of \$311 billion based on earlier studies.

Net Tax Gap Tops Quarter-Trillion Dollars

IRS enforcement activities, coupled with late payments, recover about \$55 billion of the tax gap, leaving a net tax gap of between \$257 billion and \$298 billion.

“This research confirms that the vast majority of Americans pay their taxes honestly and accurately,” IRS Commissioner Mark W. Everson said. “Even after IRS enforcement efforts and late payments, the government is being shortchanged by over a quarter-trillion dollars by those who pay less than their fair share. People who aren't paying their taxes shift the burden to the rest of us.”

Since 2001, the year covered by the study, the agency has taken a number of steps to bolster enforcement. The IRS increased its enforcement revenues by nearly 28 percent from \$33.8 billion in 2001 to \$43.1 billion in 2004. Audits of high-income taxpayers — those earning \$100,000 or more — topped 195,000 in fiscal year 2004, which is more than double those conducted in 2001. Total audits of all taxpayers topped 1 million last year — a 37 percent jump from 2001.

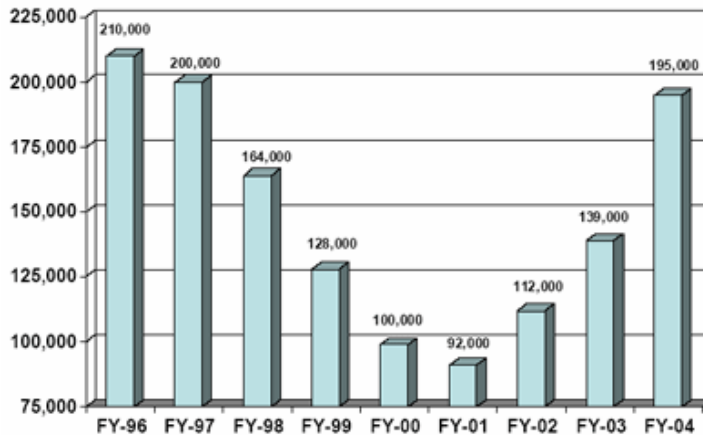


“We are ramping up our audits on high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations,” Everson said.

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High Income Audits



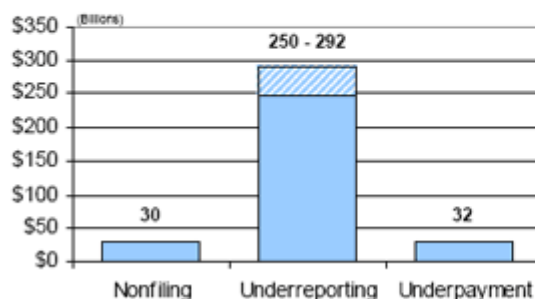
The initial tax gap findings come from a three-year study called the National Research Program (NRP), which audited 46,000 individual income tax returns for 2001. The preliminary results determined a range for the tax gap, which will be refined into final, more detailed estimates by year-end 2005. It is unlikely but possible that the final estimates of the total tax gap will fall outside the established range.

The tax gap has three components: underreporting of income, underpayment of taxes, and non-filing of returns.

The new study shows modest deterioration in tax compliance among individual taxpayers since the last study was conducted in 1988. Preliminary findings include:

- Underreporting noncompliance is the largest component of the tax gap. Preliminary estimates show underreporting accounts for more than 80 percent of the total tax gap, with non-filing and underpayment at about 10 percent each.

Underreporting Noncompliance is the Largest Component of the Tax Gap



Underreporting sources:

- understated income
- improper deductions
- overstated expenses
- erroneously claimed credits

- Individual income tax is the single largest source of the annual tax gap, accounting for about two-thirds of the total.

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- For individual underreporting, more than 80 percent comes from understated income, not overstated deductions.
- Most of the understated income comes from business activities, not wages or investment income.
- Compliance rates are highest where there is third-party reporting or withholding. Preliminary findings show less than 1.5 percent of wages and salaries are misreported.

The NRP study includes updated research only on individuals, not corporations.

Preliminary Findings Support Enforcement Efforts, Tax Reform

Everson said the study confirms two key points involving tax enforcement and simplification.

“The IRS needs to enforce the law so that when Americans pay their taxes, they are confident that neighbors and business competitors are doing the same,” Everson said. “At the same time, this research underscores the President’s call for tax reform. Complexity obscures understanding. Complexity in the tax code compromises both the service and enforcement missions of the IRS. Those who try to follow the law but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say ‘why bother.’ Meanwhile, individuals who seek to pay less than what they owe often hide behind the tax code’s complexity in order to escape detection by the IRS and pay less than their fair share.”

Everson noted that the United States tax administration system remains one of self-assessment and has a high compliance rate.

“We’re moving aggressively to reduce the tax gap,” Everson said. “With proper funding, over a number of years we will be able to close a significant portion of the gap. But no one should think we can totally eliminate the gap. That would take Draconian measures and make the government too intrusive. We have to strike the right balance.”

The next stage of the NRP will be to finish the data analysis and refine the tax gap data in late 2005. The IRS will also use the data to update its statistical tools used to select individual returns for audit, an important step in strengthening compliance with the tax system.

The IRS also plans to update estimates for other areas of the tax gap. The first part of this process will study reporting compliance of flow-through entities (S-corporations and partnerships).